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Asia's wealth market: cautious optimism dominates the investment landscape

What investment strategies should wealth managers be promoting to their Asian high net worth clients, given the current state of the global economy and financial markets? Hubbis and J O Hambro Capital Management assembled a group of 15 leading product gatekeepers at private banks in Hong Kong this April to discuss how clients can optimise their portfolios, today and tomorrow.

WITH THE DEVELOPED WORLD'S ASSET, fixed income and asset markets having been on an upward surge for nine years, and having passed the test of a rise in volatility early this year, wealth advisers have had time to assess the first quarter of 2018.

The timing for this behind-closed-doors discussion on investment themes and trends for the year ahead, therefore, was perfect.

The off-the-record discussion allowed the participants to voice their opinions and advice in an open forum, to discuss topics such as investment themes and products most relevant at this stage in the investment cycle; socially responsible and impact investing; fixed income strategies; leverage; active versus passive; alternative assets; and how the wealth managers differentiate their offerings and their approaches, including the impact of technology on their businesses.

One expert noted that the markets were highly supportive last year, especially equities and that despite the late January volatility the first quarter of 2018 was also positive, at least for his firm.

"There is a natural cycle for structured products, and the velocity of the capital slows down as markets go sideways," he explained. "But the clients still have yield-generating investments, which is what they were looking for. I am therefore comfortable with the year so far, following a good first quarter that allowed digestion of some of that large volume of business that had been done during 2017."

Equities over fixed income

The discussion focused on the big picture trends in asset allocation, namely fixed income or equities. One banker present explained that she believed that equities continued to be in favour over fixed income.

"At our bank, we are already overweight on equities and stay underweight on fixed income, where we focus mainly on the government debt side," she said. "And with the recent market pullback, we actually see improved risk-reward that would justify a further allocation to equity, mainly driven by valuations."

Fixed income, especially with heavy leveraging, has done clients

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very well in the past several years, but with rising dollar rates there is less juice to squeeze from this approach, as well as higher risk.

Many firmly believe that the 37-year super-cycle for bonds is coming to an end, or has already ended. The fantastic leveraged carries on relatively safe, investment grade bonds have primarily passed and global monetary policy is no longer so accommodating.

Dollar Libor was almost 2.8% on April 27, more than 1% higher than in October 2017. Moreover, credit spreads remain compressed, meaning that risk of leveraging bonds aggressively is now far higher than at any time in recent years.

Another expert added that the more structured capital markets products are more often used by those clients that want to be more active in the management of their portfolios and with shorter-term horizons than those buying funds, for example.

He noted that clients in the structured and capital markets need to make active decisions on a relatively regular basis and often at the same time have a broader overall portfolio allocation concerning asset classes, regions and themes.

"The capital markets demand more tactical decisions, and obviously some of our clients have long-term holdings in equities, bonds and use hedging around particularly rates and FX to then address some of the long-term issues that they might have on the managed side."

"We are flexible in our clientele, and we see a pickup in the business from the smaller type of clients, younger professionals with perhaps half a million dollars to invest and sitting on cash."

Private banks focus increasingly on portfolio oversight

"The private banking industry has been good at delivering new products to clients," he explained further, "but we have been less good at managing the investments that clients have within their portfolios on an ongoing basis."

According to him, the industry needs to spend more time advising clients what they should be exiting from within their portfolios.

"Clearly, there is a benefit to us from a commercial point of view, as disposals also mean opportunities to replace those investments with something else then," he added. "But I believe that this helps balance portfolios and builds trusted-adviser status by enhancing natural management of the portfolio."

Although markets sailed through a warning shot of volatility earlier in 2018, many now wonder how best to position their clients and whether it is either for the last leg up or the first leg down. In the face of the more significant uncer-

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tainty, improving the resilience of portfolios has become ever more critical, as valuations continue to be stretched in many sectors of the equity and bond markets.

Strategic and tactical asset allocations are now ever more central to discussions between advisers and their clients, who not only ask for safety but also want to participate in the markets while they are still positive.

Diversification is ever more vital

Firms today often report rising activity on the alternative investment side and anticipate an acceleration of that trend. Private equity and private markets such as mezzanine debt to fintech to buyouts, as well as commercial real estate have all gained greater favour, as are hedge fund opportunities.

Other alternative investments such as fine and modern art are also gaining more followers. Some bankers have told Hubbis recently that they had created vehicles that give clients a diversity of hedge fund managers through a portfolio of funds.

Socially responsible investing is much more than just a fleeting trend. Wealth advisers have realised that had not been giving this segment enough attention and are trying to build their understanding and range of offerings.

One private banker at the discussion reported that his firm also enjoyed a very positive 2017, but without having sold any structured products.

"All our growth was again driven first by the growth in our DPM [Discretionary Portfolio Management] business, which accounts for some 90% of our revenues," he said.

"Unless we face a dramatic phase of redemption in our DPM mandates, very early in the year, we can know with a low margin of error our revenues would be for the year, which is what we are striving for in our focus on DPM."

The J O Hambro team (left to right): Andrew Ang (Director of Asian Sales), Vince Rivers (Senior Portfolio Manager)

But another wealth management expert at discussion reported that the first quarter of 2018 saw a continuation of the momentum investing of 2017, including across the entire spectrum of structured products, managed and non-managed products.

Growing awareness of a new era

"Interestingly," the expert explained, "even though last year was very much equity market driven year we saw a significant increase in demand for managed products, especially funds."

He added that he found it interesting that with the recent volatility, more clients are proactively requesting managed solutions, whether funds or DPM or even illiquid markets like private equity.

"This means they do indeed realise that things are getting a bit more difficult they prefer others to constantly keep an eye on the ball, which is good especially for our fund sales," he added. "In general, despite a relatively weaker Q1 this year, we remain positive; we see

some risks have increased, but we still foresee 2018 to be quite a positive year, including equity markets."

An asset manager attending the discussion agreed, noting that he sees more and more interest in managed products, with volatility typically helping the bank to sell DPM to clients.

"As an asset manager, we are somewhat more unique than private banks here around the table for two reasons," he said. "We are flexible in our clientele, and we see a pickup in the business from the smaller type of clients, younger professionals with perhaps half a million dollars to invest and sitting on cash. Additionally, we see greater demand for US investments from our Asian clients."

One attendee commented that while Asian clients have in general tended to be reluctant to pay for advice, this characteristic is changing in China as Big Tech firms there are moving into the financial services space and being much more transparent on fees for advisory services.

are more accepting of professional advise in these increasingly complex regional and global markets."

Another expert agreed that the generally better-educated second and third generations appreciate the value of an external wealth

"Bringing in external professionals can often help these younger, wealthy generations focus on their business ideas and potential."

New generations bring new perspectives

He also reported greater interest and greater acceptance of advice-driven fees by second or third generation Asians, often pushing their parents or even grandparents to consider working with his firm.

"What we see," he explained, "is that the original money makers in Asia are more risk takers, whereas by the time we come to the third generation they are often more focused on wealth preservation and

manager. "Bringing in external professionals can often help these younger, wealthy generations focus on their business ideas and potential," he added.

Turning the discussion towards impact investing, an attendee reported that there is considerable growth in this sector, albeit from a low base. "I am very impressed by the interest of the younger wealthy—whether inherited or created—towards more altruistic type investments. Although the market evolution in this arena is still slow, look at what happened to Japan and now what is happening in Taiwan or Korea, with the government pushing public pension fund toward ESG [Environment, Social and Governance] investing."

However, another expert conceded, slightly cynically, that the growth of impact investment in Asia remains far slower than the increase in the number of conferences promoting the sector.

Nevertheless, one wealth adviser noted that family offices are selectively beginning to embrace ESG. "I think we are generally moving in the direction of clients diversifying their portfolios, increasing their asset allocations towards non-traditional asset classes, this is certainly a trend from our viewpoint."

Quantifying the managed approach

The discussion turned back towards the demands of migrating business models towards DPM. "It is certainly a challenge," said one

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expert, “but at the same time it is a huge potential source of scalability because once you have an organisation which can manage a DPM account exactly as you might manage an internal fund, you can then manage as many DPM accounts as you want with virtually the same team.”

The discussion then focused on how to convince clients that the managed approach produces outperformance, or at least justifies the fees. “Comparisons will always take place, particularly if you have a less sophisticated client,” said one expert.

“They are going to look at the performance of your DPM product against the performance of the ETF, and unless there is a huge difference, then they are often going to take the ten basis points product rather than the 1% fee product.”

On the other hand, another banker repeated the earlier view that the second and third generations of wealth in Asia are more accepting of fees, noting that they bank with fewer banks, based on their preference for simplicity and knowing how much of a burden the KYC documentation required has become nowadays.

Nevertheless, the same expert acknowledged that there is a requirement to prove to these younger generations that DPM will outperform the more traditional Asian approach. “That is one of the crucial questions which we need to resolve when promoting the DPM approach to clients,” he said. “And we also need benchmarks to prove performance and therefore help switch clients from active transactional based portfolio management to DPM.”

He pointed out that there is a need for this, so the client can reference whether they might have done better with another approach. “And this is all consistent with the theme discussed earlier of people wanting to move up the learning curve, to understand where the value proposition lies,” he said.

The consensus appeared to be that the younger generations of HNW Asians might be less price/fee sensitive than the older and founder generations, but they are also value-conscious, so they want to know how offerings compare with other beta or smart beta products. “They want to learn and are asking questions voraciously to make sure their decisions are based on sound fundamentals,” said one banker.

“Over the coming few years I see a changing pattern as the generations shift. The founder generation in Asia is tough to move from traditional active transactional based portfolio management to DPM, but that is much more attractive to the second or third generations, provided it is justified and produces the right returns.”

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A more sophisticated clientele emerges

One banker noted that a decade ago his bank regularly had clients tell them they expected returns but did not assume risk.

"It is better today as clients are more understanding of the inherent risk-return characteristics of the investments they make with us," he explained. "We try to sell a concept and explain to clients that with a certain kind of portfolio they can reasonably certain returns depending on a conservative, balanced or aggressive profile."

One wealth adviser explained that their firm's approach is a client-centric methodology, where they start with the client investment profile and agree on the risk-return pattern in the beginning.

"I believe this would be a more sensible approach to drive the client journey instead of engaging with clients in the discussion about how their portfolio with us performs relative to their portfolio with different private banks," he explained at the discussion. "An objective based investment approach is mainly the methodology that we have been upholding."

"Based on my own experience in interacting with the next generation clients," added another attendee, "I agree that they focus on the value and efficiency proposition. In fact, I have feedback from my next-generation clients that we bankers are lagging behind the service requirement of the millennial generation."

Take ESG as an example, many of our younger generation clients are approaching this on a global basis and want more product, but so far often have to take the private rather than public markets route to fulfil their objectives," he noted.

Regulation driving changing mindsets

Regulation is also a massive challenge for the wealth advisory industry; the participants, big or small, need to protect their brands and are ever more fearful of lawsuits from outside and from within.

The ever-tightening regulatory and compliance requirements have created a more significant fear factor that means the advisory community has to tread a careful line to balance its advice with downside reputational or compliance risks.

A banker explained that the regulator is tightening regulation for the wealth advisory industry to try to make life easier for the client.

"They want us to map the client, to match risk profile to make sure that there are no mismatches so that they can audit and map the outcomes," he said. "This is to some considerable extent changing the types of conversations our industry is having with clients."

The moderator turned the discussion towards a fund manager who was present and who focuses on the US healthcare and technology sectors and was on a tour of Asian clients and partners. "These sectors may not seem like they go together, but the real correlation is they are product driven."

Small tech > big tech?

He turned his attention to Big Tech, noting that the media attention surrounding Facebook had highlighted how it has been what he termed "kind of the wild west" unregulated or under-regulated environment for Big Tech thus far.

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"In the US the media companies are quite tightly regulated," he noted, "so there is a rather strict set of rules for broadcasters and the likes, magazines, TV, radio, so that when they are dealing with something especially when you get into the political environment there are certain rules they must follow."

But the internet giants so far have few rules governing their behaviour, he lamented.

"However, we have already seen the impact of these social media sites as they become more and more like media companies, so the regulators need some foothold to hold these companies responsible for what is published on their sites, whether it is generated by people or by robots and from wherever," he noted. "There is definitely a change coming."

He went on to comment that the high-flying phase of Big Tech globally might have already passed, but that there are plenty of opportunities outside the household names that have built such formidable global brands in the past decade.

"I had a weaker year last year in tech, as I was up only about 25%," he joked. "As things stand now there is still a lot of tech out there that has not yet had such a phenomenal run in recent years, giving great opportunities across large and smaller cap stocks globally."

These stocks are in, for instance, payment processing, IT services and so forth, he added.

"In short, our view is that we all spend so much of our time collectively on this group of maybe 15 names globally and that as those names correct, technology may lose its leadership," he said. "But there are many great opportunities behind those leaders where people should look for value and growth."

He explained that the two funds he works with a focus on stocks worth around USD1 billion to about USD15 billion. "These are companies that have reached some maturity but still have great opportunities in front of them," he reported. "They have attained a certain level of governance that makes them less risky than their smaller market cap peers."

He noted that in general, the belief is that the US is a better investment place for tech right now. "So we are overweight the US because we are finding plentiful opportunities there."

Measuring up the future

The discussion closed with attendees agreeing that the outlook for the financial markets is less bright than in recent years, but with a general feeling that there is little cause for alarm.

For Asia's HNW and ultra-HNW clientele, a more measured approach to risk and return is likely to benefit portfolios, and the wealth management industry is hoping that the migration of their business models toward managed investments and fee-based advice will pay off, sooner or later. ■

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